Subject:International trade

Theories of international Business/Trade

Basis of international trade can be easily explained by various theories given by various scientist and economist from time to time starting from Adam Smith. the theories which are considered as fundamental of International Trade as follows:

1. **Classical theory of International Trade**: the classical theory of International Trade was proposed by Adam Smith who introduces the principle of absolute cost advantage as the basis of international exchange of commodities. It was further developed by David Ricardo in terms of comparative cost advantage.

*The classical economist considered the principle of division of labour as the basis of international trade.

Assumptions of the classical theory of International Trade:

1. The classical economist assume two countries and two commodities model. It is further assumed that these two countries are economically at par.

2. The classical economist regarded labour as the only factor of production. This means the production cost can be expressed only in terms of labour units.

3. The classical economist ignore existence of money and consider cost of production in real terms i.e. in terms of the labour theory of value.

4. The factor of production of perfectly mobile within the country but perfectly immobile between different countries.

5. All levels are resume to be homegenous.

2.**Theory of Absolute Cost Advantage:**

Adam Smith developed the law of absolute cost advantage for international trade. According to to him trade occurs between two countries if one of them has an absolute advantage in producing one commodity and the other country having absolute advantage in producing some other commodity.

*In other words each country specialises in the production of that commodity in which it enjoys and absolute cost advantage and trades with other countries in commodities in which they enjoy absolute cost advantage. The trade between the countries would result in optimum allocation of the resources in the world and hence productivity will boost.

For example:

Suppose India produces 1 kg of rice with 10 units of labour or it produces 1 kg of wheat 20 units of labour. On the other hand Pakistan produces the same amount of rice 20 units of labour and produces the same amount of wheat 10 units of labour. Each of the countries has 100 units of labour. Equal amount of labour is used for the production of 2 goods in absence of trade in the two countries.

In absence of trade, India will be able to produce 5 kg of rice and 2. 5 kg of wheat. Same time Pakistan will produce 5 kg of wheat and 2. 5 kg of rice. But when trade is possible between two countries, India will produce only rice and exchange a part of rice output with wheat from Pakistan. Pakistan will produce only wheat and exchange a part of the wheat output with rice from India which was producing 7. 5 kg of food grains in absence of trade will now reduce 10 kg of food grains. Thus, the theory of absolute cost advantage explains how trade help increase the total output in the two countries.

3. **Theory of comparative cost advantage:**

This theory was given by **David Ricardo.** According to this theory the countries in the long run will tend to specialise in the business of those goods in whose businesses they enjoy comparative low cost advantage and import Other goods in which the countries have comparative cost disadvantage, if free trade is allowed. Best specialisation helps the mutual advantage of the countries participating in the international trade.

David Ricardo illustrated the comparative cost theory in 1817. He also used a two commodity model. The conclusion of his model are:

1. Business between two countries is profitable when a country produces one commodity at the lower cost then other country and that other produces another commodity at a lower cost then the formal country.

2. Business between two countries is also profitable when one country produces more than one product efficiently but when it produces one of these product comparatively at greater efficiency than the other product.

3. Both the Nations can engage in international business when one country specialises in the production in which has greater efficiency in production.

4. **Factors proportion theory:**

This theory was first propounded by **Eli Heckscher (1879 -1952)** n later refined by Swedish economist **Bertil Ohlin(1899- 1979**) in 1933.

Ohlin accepts David Ricardo view that the comparative cost difference is the basis of international trade. But Ricardo did not explain the cause of comparative cost difference in the production of any two commodities in any two countries. So the modern theory begins where the ricardian theory ends.

In 1919 Professor Heckscher pointed out that the international trade is caused due to the differences in the comparative cost resulting from the difference in relative scarcity (i.e. relative prices) of the factors of production in the two countries. Ohlin developed this idea further. According to Ohlin the differences in the factor prices are due to the differences in the factor endowments in different countries and the differences in production functions for different commodities. Hence, Ohlin theory can be called factor endowment theory. For instance, a country which has abundant labour and scarcity of capital will specialise in the production of labour intensive goods and export them and vice versa.

Assumptions of Factors proportion theory:

-there are two countries or region say X and Y each having a free paper currency and each capable of producing any two commodities.

-there are two factors of production I.e. labour and capital.

-the factors of production are fully mobile within each region of a country while they are relatively immobile in between any two regions or two countries.

-the method of production and production function for both the commodities are same in different countries.

-there is a competition in all the markets.

-each factor is fully employed in each country with or without trade.

-there are no transportation or information cost.

-there are no import tariffs or other barriers to trade.

-the production functions for each good are the same in the two countries.

-all production functions are linearly homogeneous.

-all production functions are immune to factor intensity reversal.

-both countries produce both goods with or without trade.